Investing Bond Proceeds (AKA: THE DAY AFTER!)

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The Funs Over and The Real Work Begins

- Managing Debt
  - It’s your responsibility
  - It’s real money
  - The impact of your actions (or lack thereof) will be felt for a long time

Why Bother Worrying About Investments?

- Interest costs accrue on bonds immediately
  - Negative carry increases financing cost
  - Improved investments lower overall borrowing cost
  - Increased returns reduces drain on General or Enterprise Fund
- Impact on Project funds
  - Net funding + more earnings = smaller bond issue
  - Gross funding + more earnings = more project funds
- Impact on Reserve Funds
  - More earnings = less net debt service (this is a good thing!)

Principles of Investment Management

- Safety
  - Minimize credit risk
- Liquidity
  - Ensure that funds are available for project costs, reimbursements and debt service payments
    - Minimize market price risk
    - Minimize reinvestment rate risk
- Yield
  - Generate consistent risk-adjusted returns

Formulating an Investment Strategy

- When do I start?
  - Once the structure and sizing of the debt is known
  - If you plan on using an investment advisor, do so at the beginning of your debt issuance, not at the end.
- Integral part of debt strategy
  - Do you net-funding or gross fund?
  - How confident are you in your project cash flow projections?
- Surety or Cash-funded DSR
- Can’t I wait for rates to go higher
  - Yes….No….Maybe….Well, it kind of depends….

Formulating an Investment Strategy

- Determine origin, characteristics, and expected uses of funds
  - Short and long-term funds
  - Asset / liability matching
  - Determine appropriate duration
- Identifying Investment Alternatives
  - Understand Legal Parameters
    - Applicable Sections of Government Code
    - Applicable Investment Policy
    - Applicable Bond Documents
      - "Permitted Investments" as defined in documents
    - External Investment Approvals
      - Insurers, rating agencies, etc.

Formulating an Investment Strategy

- Identify candidate investment vehicles
  - Short term options
    - Pooled Investments
    - LGIPs, money market funds, county pools, internal
  - Medium term options
    - Structured Products - Guaranteed Investment Contracts, Forward Delivery Agreements
    - Portfolio Management
      - Treasuries, Agencies, Medium-term notes
  - Long term options
    - Structured Products - Guaranteed Investment Contracts, Forward Delivery Agreements
  - Surety

Formulating an Investment Strategy

- Prepare prospective arbitrage rebate models for competing investment alternatives
  - Consider expenditure exceptions if positive arbitrage achievable in project funds
  - Consider waiving temporary period if negative arbitrage guaranteed in project funds
  - Other considerations
    - Refunding/Refunded Deals
      - Transferred proceeds rules
      - Anticipating/Incorporating those rules into an investment strategy (especially in Reserve Fund)

Typical Investment Options

- Pooled Investments
  - SEC Registered Money Market Funds (MM) and Trustee Sweep Accounts
  - LGIPs, City and County Pools
  - Internal pools
    - Controls
    - External Rating
    - Bond Insurer approval

Typical Investment Options

- Structured Products
  - Guaranteed Investment Contracts
    - Involves a deposit with a counterparty
  - Forward Delivery Agreements
    - Not itself an investment, but rather a contract pursuant to which investments are to be purchased
  - Repurchase Agreements
    - Types of collateralized agreements

Typical Investment Options

- Providers of Structured Products
  - Guaranteed Investment Contracts
    - Primarily bond insurers and large insurance companies
      - AIG, Ambac, FGIC, FSA, MBIA, CDC, BLB
  - Forward Delivery Agreements and Repo's
    - Banks/Primary dealers
      - Bank of America, JP Morgan, Lehman, Salomon

Structured Products - Principles (Safety)

- Key Provisions to Consider in Structured Products
  - Guaranteed Investment Contracts
    - Initial counterparty financial strength
    - Downgrade provisions, collateral/termination
  - Forward Delivery Agreements
    - Counterparty risk is limited to underlying security and to reinvestment risk
    - Eligible securities and providers
  - Both transfer market price risk to provider

Structured Products - Principles (Liquidity)

- Investment agreements can be tailored to the expected requirements of any fund
  - Reserve, Project, Debt Service, other?
  - Draw flexibility is “built-in”
- Project / Acquisition Fund
  - Full Flexibility
- Reserve or Debt Service Fund
  - Semiannual draws to pay debt service
  - Take advantage of predictability of cash flows

Structured Products - Principles (Liquidity)

- Transfer reinvestment risk and market price risk to the provider
  - If positive arbitrage can be achieved, this "transfer" is free to the issuer
- Achieve a proper matching of average life of investments with expected uses
  - similar to a managed portfolio, but with reduced administrative burden

Structured Products - Principles (Yield)

- Issuers often overestimate liquidity needs
  - Average life of investments is shorter than necessary, yield suffers as a result
- IAs match expected life of funds while preserving liquidity
  - With an upward sloping yield curve, investment returns are increased

Portfolio Management

- Requires ongoing oversight, administration
- Issuer retains and must manage risks
  - Reinvestment risk
  - Market price risk
- Permitted investments - individual securities
  - Treasuries, Agencies, Medium-term notes, Municipal bonds, Commercial paper, Certificates of deposit
  - Others, combinations

Portfolio Management

- Safety considerations
  - Credit risk
  - Market price (interest rate risk)
- Liquidity considerations
  - Fund characteristics
  - Expenditure dates determine liquidity characteristics
  - Matching cash flows reduces risks

Portfolio Management

- Yield considerations
  - Can provide sufficient yield performance
  - Careful not to reach - consider liquidity
  - Combining differing maturities reduces risk

Conclusion

- DON’T DROP THE BALL!!!
  - As with investing any public funds, your objectives are Safety / Liquidity / Yield
  - The difference is that you usually have less flexibility and unique cash flow considerations
  - It’s GOOD to owe rebate!
  - Consider your legacy (make it a good one!)
    - Document, Document, Document…….
    - Take the time to do the job right
    - Fulfill your responsibilities